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In the Supreme Court of the United States

OCTOBER TERM, 1933

No. 158

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES J. CANFIELD

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

The problem in this case is to determine what part of a dividend declared and paid in 1923 was derived from earnings accumulated by the corporation prior to March 1, 1913, and was therefore exempt from tax, and what part was from earnings accumulated after that date and was therefore taxable. The respondent approaches the question by endeavoring to ascertain the amount subject to tax. The Commissioner, on the other hand, taking the

[1] The arguments herein advanced apply equally to the companion case of *Thorsen* v. *Commissioner*, No. 212. To avoid repetition we are filing no separate reply or supplemental brief in that case.

view that dividends generally are income to the recipients (see *Lynch* v. *Hornby,* 247 U.S. 339) and that Section 213 (a) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 238, taxes "income derived from any source whatever" unless such income is specifically declared deductible or exempt, seeks to determine what portion of the dividend is exempt from tax.

The Commissioner's approach to the question seems justified, not only by the history of Section 201 of the Act, which is discussed on pages 8 and 9 of our original brief, but by the express provisions of subsection (b), which reads in part:

> (b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; * * *

It is argued on behalf of the taxpayer that this provision was inserted in the 1917 Act with reference to the taxation of corporate distributions at the rate prevailing in the year of their accumulation, and was continued in the 1918 Act and later revenue statutes only for purposes having to do with personal service corporations. The language of the subsection is, however, much broader than this, and although it undoubtedly had reference to these matters, we submit that it is also of general application. In the 1918 Act this provision appeared in the following form:

> (b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. *Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913,* or, in the case of a personal service corporation, from the most recently accumulated earnings or profits; * * * (Italics ours.)

The passage in italics clearly had no application to personal service corporations, since special provision was made for them. Subsection (b) created two presumptions: first, that a distribution was from earnings or profits, rather than from capital; and second, that it was from earnings or profits accumulated since February 28, 1913, as distinguished from those accumulated prior to that time. The effect of those presumptions was, we submit, to place upon the taxpayer the burden of showing that a dividend received by him was not taxable, either because it was a return of capital or because it was derived from sums earned before March 1, 1913. There seems to be no justification for construing the analogous provision of the 1921 Act, which is framed in the broadest terms, as discarding the two presumptions mentioned and retaining only the third, relative to personal service corporations. It seems reasonably evident that Congress, realizing that all three presumptions could

be included in a single provision, reframed the section accordingly.

But whether the burden be upon the Commissioner or upon the taxpayer, we contend that subsections (a) and (b) are essential parts of the same general provision, and that neither one can be correctly understood without taking the other into consideration. The respondent appears to look upon subsection (a) alone as determinative of the issues raised, and argues that (b) performs only certain subordinate functions. We take the position that doubts arising as to the proper construction of (a) can be resolved only by referring to (b), and that the emphasis in Section 201, when that section is read as a whole, is laid upon the exemption of earnings accumulated prior to March 1, 1913, rather than upon the taxation of earnings subsequently accumulated.

In the last analysis, the respondent's position is wholly dependent upon the proposition that the statute contemplates two "wholly independent" periods, the first embracing all time prior to March 1, 1913, and the second all time between that date and the date of the dividend payment. If this proposition is unsound, it seems that the respondent's entire argument must fall.

The respondent asserts that the intention of Congress to create two wholly independent periods

is self-evident [2], but we find nothing in the brief to support this interpretation of the Act. That Congress regarded March 1, 1913, as marking a point of division for certain purposes is, of course, beyond dispute; but whether it contemplated that the periods before and after that date should be independent of each other, in the sense that nothing occurring in the later period could possibly reduce the mass of earnings in existence at the close of the earlier, is a wholy different question. The respondent's argument seems to go too far, for he says (Br., p. 12) that "If there were a deficit in 1913, instead of a surplus, that of course, would have to be made up, but the method of determining the accumulation would, in fact, remain the same under all factual situations * * *." Yet it would manifestly be impossible to restore a 1913 deficit out of later earnings if, as the respondent insists, the two periods must be kept entirely separate and independent of each other. Nor, if the deficit is to be restored, will earnings accumulated in the post-1913 period be the net of all operations during that period; they will plainly be the net of those operations *less* the amount of the pre-existing deficit.

In the brief for the petitioner in the *Thorsen* case, No. 212 (p. 28), reference is made to certain

[2] See respondent's brief, p. 7; brief for petitioner in the *Thorsen* case, p. 15.

committee reports relative to the 1924 Act, in which it was said that the theory upon which earnings accumulated before March 1, 1913, are allowed to be distributed free from tax is that the distribution constitutes a return of capital to the stockholder. We submit, however, that upon analysis this statement will be found to be of little value. Distribution of earnings accumulated prior to March 1, 1913, is, in fact, no more a return of capital than is a distribution of earnings accumulated after that date. See *Lynch* v. *Hornby,* 247 U.S. 339. It is apparent, therefore, that the statement of the committee can mean no more than that Congress believed itself bound to treat ante-1913 earnings as capital, and that having so treated them to the extent of permitting their distribution free from tax it did not intend that the taxpayer should reap the benefit of the exemption a second time when the stock was sold at a profit. Moreover, the same committee report from which the taxpayer quotes indicates that Congress has not treated these earnings as capital for all purposes. We refer to the following statement (H.Rep. No. 179, 68th Cong., 1st Sess., p. 11):

> Since distributions out of earnings and profits accumulated prior to March 1, 1913, and distributions out of capital are in some instances treated differently, it is material to know the source of a given distribution, even though all earnings and profits accumulated since March 1, 1913, have been dis-

> tributed. Consequently, in section 201 (b) of the bill the presumption that every distribution is out of earnings and profits applies to all earnings and profits, whether accumulated prior or subsequent to March 1, 1913, thus clarifying and making more certain the law.

It may be observed, also, that the 1921 Act did not treat these distributions as a return of capital for the purpose of computing gain upon the subsequent sale of the stock, but only for the purpose of determining the amount of a loss. See *Newman* v. *Commissioner,* 9 B.T.A. 158. Section 201 (b) of the 1924 Act changed the law in this respect.

In our original brief we sought to distinguish the case of *Hadden* v. *Commissioner,* 49 F. (2d) 709 (C.C.A. 2d), on the ground that the corporation there had a deficit on March 1, 1913, which had to be made up before there could be earnings available for distribution. The respondent challenges this distinction, stating that the corporation had an earned surplus on March 1, 1913, and that the case is therefore directly in point. We have been unable to find anything in the decision as reported or in the related cases cited on page 13 of the respondent's brief justifying this statement. The taxpayer in the *Hadden* case took the position that no surplus existed, whereas the Commissioner insisted that the absence of a surplus had not been shown. The court apparently agreed with the taxpayer, for it said (p.

710) that the company "had no profits from its organization until March 1, 1913," and that "petitioner's contention is that there were no earnings or profits accumulated on March 1, 1913." Its opinion seems plainly to proceed on the assumption that the petitioner's contention was correct. If the court was mistaken as to the facts, nevertheless its decision must be read in the light of the facts as it saw them. If in fact there were earnings accumulated before March 1, 1913, we submit the decision was erroneous.

Respectfully submitted.

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